Ontario

Ministry of
Transportation and
Communications

THE PRIVATIZATION OF TELEGLOBE CANADA:

ISSUES AND CONCERNS

COMMUNICATIONS DIVISION
JUNE. 1985

CONTENTS

	Page No.
INTRODUCTION	1
BACKGROUND	2
ONTARIO'S POLICY OBJECTIVES	4
CONSUMER INTERESTS	6
INDUSTRY STRUCTURE	8
REGULATION	10
CANADIAN INTERNATIONAL INTERESTS	12
SUMMARY OF BIC EVALUATION CONCERNS	14

INTROCUCTION

It has become a matter generally known that the federal government has stated its intention to privatize Teleglobe Canada before the end of 1985. It has also been acknowledged that the proposed privatization raises a number of policy issues and concerns. The importance of those policy issues is what prompts the Government of Ontario to comment on the implications of the "how and to whom" of the proposed privatization. There is no intent to comment on the federal government's overall privatization strategy. Ontario, has on a number of occasions, strongly recommended the development of a national telecommunications policy. The privatization of Teleglobe offers a unique opportunity to take further specific steps leading towards a more complete national telecommunications policy. In addition, the time frame within which the federal government is planning to acomplish this goal is short. Therefore, it is necessary to raise Ontario's concerns at this earliest opportunity.

It is also beyond the scope of these comments to deal with the questions raised by the possible change in the policy by which Teleglobe is the single interface for Canada with overseas carriers and Intelsat. This policy is clearly affected by the potential growth of international bypass via the US. A shirt in the single interface policy would create considerable uncertainty with respect to the future of and appropriate price for Teleglobe. This paper describes briefly the background of Teleglobe Canada, and sets out Ontario's policy objectives for telecommunications generally, and with respect to this issue specifically . The paper then goes on to describe the Government of Ontario's concerns regarding impacts on: consumers, industry structure, regulation, and the protection of Canada's international interests. It concludes by suggesting certain criteria which the federal government may wish to apply in evaluating the various bids submitted for Teleglobe's purchase.

BACKGROUND

Teleglobe Canada was established as the Canadian Overseas Telecommunications Corporation (COTC) in 1950 with a legislative mandate to provide overseas telecommunications services for Canada and to participate on Canada's behalf in various international communications organizations such as the CTO, Intelsat, Inmarsat and the ITU. The facilities the corporation took over were those of the Canadian international operations of Canadian Marconi Ltd. and Cable and Wireless Ltd. Two purposes were alluded to in the parliamentary debates on the act which established the C.O.T.C. (later Teleglobe Canada). The first was that Canada had made a commitment during the 1945 Commonwealth Telecommunications Conference to public ownership of the providers of overseas telecommunications services. Second, it was felt that national security related to overseas telecommunications facilities would be promoted by public ownership.

Since 1950 international telecommunications demand has expanded enormously because of economic growth and rapid technological developments which have resulted in higher quality and lower priced services. Teleglobe has also grown rapidly and profitably. Nevertheless, the corporation, with over $200 million in annual revenues, remains a relatively small player in the Canadian telecommunications scene - accounting for only about 3% of the Canadian market.

Financially, the corporation gives an impression of strength and security. It has assets of $574 million and profits of over $40 million per year. The corporation has benefited from the policies of the government, which until recently required minimal dividends, although corporate income taxes have been paid. The result has been that retained earnings have been rather large in proportion to the fixed capital stock of the company, compared to other telecommunications companies.

The action of the Board of Directors in declaring a one-time dividend of $108 million in March of 1985 appeared to recognize the somewhat unusual nature of Teleglobe's financial structure.

A significant policy aspect of Teleglobe is that it has been unregulated throughout its life as a Crown corporation. This has created little in the way of policy debate up to now. However, the prospect of privatization creates a new situation.

Allegedly, there have been as many as twenty bidders for Teleglobe - including Telecom Canada, CN and CP Ltd., Crowntek and an employee group, among others. There would be potentially significant effects on Canada's telecommunications industry regardless of the bidder selected or conditions of sale.

ONTARIO'S POLICY OBJECTIVES

Ontario's objectives for telecommunications, broadly speaking, focus on three concerns. These are:

1. To maintain and enhance access to a range of telecommunications services for residential and business customers.

2. To improve the efficiency and effectiveness of telecommunications networks and services, and,

3. To promote economic growth through the telecommunications system.

The policy framework that Ontario believes best contributes to the achievement of these objectives is a combination of regulation and competition. Where telecommunications markets are dominated by carriers with substantial monopoly power, it is beyond question that there is a role for regulation to protect user interests. Except for customer premises equipment, the telecommunications market is largely characterized by monopoly. Nevertheless, technological developments in telecommunicatons increasingly offer the potential for competition to play a larger role in promoting access, efficient allocation of resources and economic growth. Wherever competition is practical and beneficial in supporting these objectives it should be promoted.

With respect to Teleglobe Canada the abovementioned concerns apply. Teleglobe has significant monopoly power through its connecting agreement with Telecom Canada for overseas Long Distance Calling. At the same time, international competition for business services is increasing and Teleglobe needs to be competitive.

That being the case, Ontario has identified the following objectives relating to the proposed privatization of Teleglobe:

1. To ensure that user interests relating to access and rates are not adversely affected;

2. To ensure that the resulting industry structure is in the best interests of carriers and users;

3. To ensure that an appropriate regulatory framework for Teleglobe Canada is established;

4. To protect Canadian international economic and security interests; and,

5. To suggest appropriate criteria for the evaluation of bids.

CONSUMER INTERESTS

As referred to above, Teleglobe has benefitted from the policies of the Canadian government that did not require payment of dividends prior to 1980. One can only speculate, in the absence of a specific tender, as to what the balance sheet of a privatized Teleglobe would be like. It is fairly likely, however, that the following effects might occur:

1. The working capital could be reduced substantially.

2. The debt-equity ratio may rise from the current level of 58%.

3. Interest expenses could rise to market rates.

4. Interest earnings may decline because of the probable reduction in working capital.

5. Regular dividend payments could be somewhat higher than has been the case in the past.

6. The corporation would be dependent on market sources of funds for investments to a significant extent in the future.

7. The cost of capital allowed by the regulator may be less than has been indicated by the previous rate of return resulting in potentially lower rates for overseas services.

8. The settlement with Telecom Canada might be adjusted as a result of regulatory review.

It should be borne in mind that Teleglobe is highly capital intensive - even for a telecommunications firm.

The net result for telecommunications rates and costs is difficult to predict because the factors may operate to generate both upward and downward pressures on rates.

A similar concern arises with respect to the price paid for Teleglobe. Normally when regulated companies change hands the price corresponds closely to book value. If the price were higher, this could translate into a larger rate base for regulatory purposes, and an increase in revenue requirement.

The result might be that a higher than book value price for the corporation would lead to higher telecommunications rates for monopoly services. Alternatively, a regulator might decide to disallow the excess of the price paid for the assets over book value as part of the regulated rate base. This would not be particularly attractive, however, to a prospective purchaser.

Ontario would regard with some concern any development related to the sale or the financing of a privatized Teleglobe that would provide upward pressure on rates for monopoly services.

An additional concern that may arise from the purchase of Teleglobe by a telecommunications common carrier relates to the incentive to provide equal access to competing carriers. Teleglobe is not affiliated with an existing carrier. Therefore, no incentive to discriminate in the provision of access to connecting carriers exists. If, however, an existing carrier is closely associated with Teleglobe, an incentive to discriminate among competing carriers could exist. For example, the federal government should consider what might be the impact on an international service offered by one carrier, should another carrier gain control of Teleglobe. Regulatory oversight would then become necessary to ensure non-discriminatory access. This might be expected to entail stringent structural separation and conduct requirements between Teleglobe and the affiliate carriers. Even such regulatory oversight, however, may not be perfectly effective in ensuring non-discriminatory access.

INDUSTRY STRUCTURE

The structure of the U.S. Telecommunications industry has been altered substantially as the result of the Greene decision, and the official policy of the U.S. government to promote competition in telecommunications. The U.S. government's policy now extends to an official sanction for competition in the international sphere. Pro-competitive international telecommunications policies are also being supported by the United Kingdom and Japan. Inasmuch as these three countries are major sources of international traffic, the potential for a more competitive international telecommunications environment is very real.

Given the growth of international competition it is useful to consider how the privatization of Teleglobe could conceivably contribute to strengthening the efficiency and international competitive strength of the organization. Teleglobe at present amounts to approximately 3% of the Canadian telecommunications industry. As a carriers' carrier the corporation has limited direct access to customers. Thus, it is appropriate to consider whether certain new structures involving Teleglobe as a result of privatization may allow for a more competitive and efficient organization with greater market "reach" and resources.

Domestically, competition in private line services and customer premises equipment has altered Canadian telecommunications. However, competition in message toll services is unresolved pending the decision of the CRTC. Clearly, an association of Teleglobe Canada with Telecom Canada or Bell Canada, established monopoly carriers, would have a different impact on the potential for expanded competition in the domestic market than other bidders. It is, therefore, necessary that the federal government consider what actions it is prepared to take

to give meaning to national telecommunications policy with respect to competition. Ontario's view is that competition can and should have an enlarged role in telecommunications policy, as evidenced by the Province's position on the application to provide interexchange competition now before the CRTC.

Finally, it must be considered that the rising level of competition in the industry, rapidly evolving technologies, and requirements for large long term investments require a high level of expertise among management. Risks are becoming greater in telecommunications. Management which is unfamiliar with telecommunications may be somewhat more prone to serious, costly errors.

REGULATION

While Teleglobe Canada is not currently subject to formal regulation, it is inconceivable that as a monopoly privatized corporation it should continue to be unregulated. As a result, the federal government must consider how and by what agency Teleglobe should be regulated. The CRTC would seem to be a natural choice as the agency to regulate the corporation, because of its experience in telecommunications. In addition, the CRTC is well placed to provide an overview of national telecommunications policy issues.

The federal government must, in any case, resolve how to treat Teleglobe Canada's international activities. A regulatory agency could review and approve all of Teleglobe's international agreements and ventures. This could be a taxing task as Teleglobe has agreements with over 250 countries for the exchange of traffic. Moreover, the jurisdiction of the regulator to enforce its decisions in the international sphere would be limited.

The federal government's options range from a legislative exemption from regulation of Teleglobe's international operations to full regulatory scrutiny. A flexible midway solution, however, may be to allow for the Minister of Communications to give binding directions to the regulator on these matters. This would limit neither government nor the regulator to a specific long term direction.

In respect of certain regulatory concerns, the federal government is not bound to make any immediate choice, but should be aware of the implications of regulation for Teleglobe Canada's future activities. First, since Teleglobe Canada has begun to participate in competitive activities, such as Globetex and Globesat, a question arises as whether the corporation's monopoly revenues are cross-subsidizing its

competitive activities. This question must be examined by a regulator. In addition, the question of appropriate monitoring requirements and controls upon cross-subsidization by Teleglobe must be dealt with.

Second, inasmuch as Teleglobe's capital structure and revenue requirement have never been reviewed publicly, and because privatization will alter them, there is a need for a comprehensive review of Teleglobe's revenue requirement.

Third, Teleglobe now has had considerable flexibility in pricing and marketing competitive services. Under regulation some of that flexibility would be lost in order to comply with rate filing and information requirements.

CANADIAN INTERNATIONAL INTERESTS

Teleglobe Canada represents national interests in overseas telecommunications matters as Canada's participant in the Commonwealth Telecommunications Organization, in the International Telecommunications Union, in Inmarsat and as a shareholder and board member in Intelsat. As such, Teleglobe must bring a knowledge of a variety of technical issues and a sensitive awareness of national interests as they relate to telecommunications. The federal government must therefore consider the suitability of various bidders to continue to carry out this role.

Teleglobe Canada has, in the pursuit of its mandate, given considerable attention to maximizing the opportunity for Canadian manufacturers to participate in its activities. Inasmuch as the corporation must negotiate with other national carriers with a similar mandate, this is the only way to ensure that Canadian business gains a reasonable opportunity to share in overseas telecommunications business. It is reasonable, therefore, to consider what the impact of privatization may be on the future opportunities for Canadian suppliers, especially as the incentive to maximize profits for the corporation or a corporate connection may reduce those opportunities.

At the inception of Teleglobe Canada, national security was a prominent concern. It is still reasonable to consider the implications of a foreign owner for Canada's overseas telecommunications facilities. Control of overseas telecommunications remains critical for national security and flexibility of Canadian foreign policy. The federal government must naturally consider whether there is a risk of diminished responsiveness to Canadian foreign policy associated with certain bidders. In that regard it must be considered that foreign nationals who are officers of the corporation may be

bound or consider themselves bound by the laws and foreign policies of their native countries. This could potentially pose an unacceptable conflict of responsibilities. The federal government should carefully consider these issues related to foreign ownership, particularly since a number of Canadian groups with sufficient capital are likely to be bidding.

SUMMARY OF BIC EVALUATION CONCERNS

The foregoing discussion identifies the concerns which, in the view of Ontario, are appropriate to consider in evaluating the various bids for Teleglobe Canada. These are summarized below:

1. The federal government should not select a bid which because of the price paid for Teleglobe and/or the financing, would tend to raise monopoly service rates.

2. The federal government should avoid the selection of a purchaser which would have a negative impact on equal access for competing carriers to Teleglobe services or facilities.

3. The bidder chosen should not be one who would be likely to inhibit competition, or the potential for enhanced competition, in the domestic market.

4. The purchaser should be capable of competing effectively with foreign competitors and should, if possible, enhance Teleglobe's international competitiveness.

5. The federal government should put in place a regulatory framework which recognizes the monopoly power of Teleglobe in the international long distance market and deals effectively with that power.

6. The federal government should resolve the matter of regulatory oversight of Teleglobe's international dimension in a manner that strikes a reasonable balance between the need for regulatory review of the corporation and the practicality of review of dealings with overseas sovereign carrier agencies.

7. There should be a regulatory review of Teleglobe's competitive activities and pricing, and consideration of the impact of such review on the corporation.

8. The federal government should recognize the need for a responsive relationship with the overseas carrier as a representative of Canadian telecommunications interests abroad, and consider this in the evaluation of bids.

9. The federal government should consider the incentive of a privatized Teleglobe to promote Canadian commercial interests and the potential need for directions to the corporation's regulator.

10. Inasmuch as Canadian overseas telecommunications services and facilities are critical to Canada's security and freedom of action in foreign policy, the advisability of sale to foreign bidders should be carefully considered.